Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:OHI:CIN:TL-N-1693-99
JEKagy

date:

to: Chief, Examination Division, Ohio District
ATTN: Sheryl Stonecipher

from: Assistant District Counsel, Ohio District

subject: [redacted]

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On March 17, 1999, we forwarded a memorandum, subject as above, addressing your request for Counsel's review of the methodology utilized in a valuation report received from [redacted], regarding the voting and non-voting stock owned in a closely-held corporation known as [redacted]. As was previously discussed telephonically with Estate Tax Attorney Sheryl Stonecipher, based in part on the Tax Court's recent opinion in Simplot v. Commissioner, 112 T.C. ___, 112 T.C. No. 13 (March 22, 1999), we are modifying our recent memorandum.

Our March 17th memorandum voiced concern over the "control" factor applied to the [redacted] Class A voting shares. [redacted] applied a [redacted]% "control" premium to the Class A voting shares since the shares represented a controlling interest in the company. [redacted] calculated the premium by multiplying the overall value of the company by the [redacted]% factor and adding that product to the value of the [redacted] shares of Class A stock.

Our earlier memorandum advised that the premium should be calculated as a percent of the value of the stock being bought or sold, not as a percentage of the whole company. We opined that such treatment was appropriate in light of the opinion in Estate of Curry v. United States, 706 F.2d 1424 (7th Cir. 1983). However, in light of the Tax Court's opinion in Simplot v. Commissioner, 112 T.C. ___, 112 T.C. No. 13 (March 22, 1999) and based upon conversations with both [redacted] and our National Office counterparts, we are comfortable with [redacted]'s methodology, and encourage your pursuit of the issue utilizing the methodology contained in his current report.

In Simplot, the Court was faced with the valuation of the decedent's 18 shares of voting stock and 3,942 shares of non-voting stock. Both blocks of stock amounted to only a minority interest of each type of stock. The Simplot Estate claimed that the value of both the voting and nonvoting stocks were the same and of limited value. The Service valued the shares differently, initially ascribing a higher value to the voting than the non-voting stock, and then applying a voting premium to those shares, calculated as a percent of the company's overall equity value.

The Court found that the two types of stock should be valued separately, not aggregated, as had been done by the Estate. The Court reasoned that the voting shares possessed the potential for participation in the management of a company that held significant assets not reflected by the corporate books. To capture the premium associated with the voting rights, the Court applied a 3% voting premium, calculated as a percent of the equity value of the total company.

During telephone discussions with [redacted], he articulated his position that the two types of stock in [redacted] would trade separately, that is, as between a willing buyer and willing seller, the non-voting stock would be an attractive investment without need to own the voting stock. He further opined that the voting stock, if valued on a minority basis, would not command a premium. [redacted] felt that the voting power associated with a majority block of stock required the application of a premium, and that, like Simplot, the "unusual corporate structure" made typical valuing techniques inapplicable. In order to capture

control premium associated with controlling this business, [redacted] firmly defends the opinion that the premium ascribed to the voting shares must be determined as a percent of the equity value of the corporation. The [redacted]% premium used by [redacted] was determined by a study performed of similarly situated stock sales.

The outcome of any trial on this type of issue will turn on the ability of the expert to convince the Court of the logic and appropriateness of the positions espoused. Because of this Office's previous experience with [redacted], we are confident that he will prove able to support his position and convince the Court to accept his methodology. Given the factual similarities between [redacted] and Simplot, and the ability of [redacted] to articulate his position, we believe [redacted]'s expert opinion should be followed. The Simplot opinion establishes the Court's willingness to accept differing methodologies in cases where the corporate structure fails to fit within the normal capital structure and where the expert can convince the Court of the appropriateness of the methodology applied. Given [redacted]'s expert opinion supporting the methodology used, we believe it should be adopted for purposes of the facts in this case.

We hope the forgoing clarifies our position on this unusual valuation issue, but if additional questions exist or as new questions arise, please contact the undersigned at (513) 684-3211.

MATTHEW J. FRITZ
Assistant District Counsel

By: _____
JAMES E. KAGY
Special Litigation
Assistant

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Internal Revenue Service

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This memorandum responds to your request for Counsel's review of the methodology utilized in a valuation report received from [redacted], regarding the voting and non-voting stock owned in a closely-held corporation known as [redacted]. Based upon our initial review, we offer the limited comments which follow.

Our only serious concern stems from the "control" factor applied to the [redacted] Class A voting shares. [redacted] applied a [redacted]% "control" premium to the Class A voting shares since the shares represented a controlling interest in the company.

A control premium has been recognized as the per share value of a block of stock that controls a corporation. For instance, in Phillip Morris v. Commissioner, 96 T.C. 606, 625 (1991), aff'd without opinion, 970 F.2d 897 (1992), in arriving at fair market value of a control block of stock, the Court equated the control premium with the value of the right possessed by the owners of a block of stock to determine corporate policy, above and beyond the value attributable to the corporation's underlying assets under traditional valuation methodologies. Thus, a control block of stock may be entitled to a value greater than the value ascribed to a block of stock which does not control a corporation. See Whittemore v. Commissioner, 127 F.Supp. 710 (D. Conn. 1954). A control premium is appropriate where evidence exists establishing that the value of similarly held controlling blocks of stock reflect the application of "control" premiums.

The appropriateness of a control premium is a mediate question fact, i.e., a factor used in determining the fair market value of the estate, the ultimate question of fact. See, e.g., Dahlgren v. United States, 553 F.2d 434 (5th Cir. 1977). Although, from the report itself, we cannot determine whether the application of a premium is justified, such a determination is a matter of fact under the province of the District Director. We assume for purposes of this memorandum that [redacted] has adequately established the appropriateness of applying a control premium in this instance.

[redacted] calculated the premium by multiplying the overall value of the company by the [redacted]% factor and adding that product to the value of the [redacted] shares of Class A stock. We do not agree with the calculation of the control premium. From our perspective, the premium should be calculated as a percent of the value of the stock being bought or sold, not as a percentage of the whole company. If the correct premium is [redacted]%, then the product of the value of the block of control stock multiplied by the [redacted]% factor generates the premium which must be added to the value of the control block.

The harder question is whether the control premium should also be applied to the non-voting stock owned by the decedent. In this instance, the decedent owned [redacted] non-voting Class B shares of the corporation. The question is whether to assign a premium to only the [redacted] Class A voting shares, technically constituting the control block, or to the combined bundle of voting and non-voting shares owned at death by the decedent.

We recommend that once [redacted] is satisfied with the appropriateness of a control premium and has verified the correct premium to be applied, the premium should be applied to the integrated block of stock owned by the decedent, i.e., both the Class A voting and the Class B non-voting shares. We believe that such treatment is appropriate in light of the opinion in Estate of Curry v. United States, 706 F.2d 1424 (7th Cir. 1983). See also, Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1982); and LTR 8907002, dated November 1, 1988.

In Curry, the decedent owned 53% of the outstanding common shares and 28.8% of the non-voting common stock. As a matter of valuation, the taxpayer claimed that the non-voting stock was worth considerably less than the voting shares. On the point of valuation, the Court held:

> [B]oth the law and common sense compel the conclusion that the fair market value of the non-voting stock in the hands of an estate with sufficient shares of voting stock to ensure the estate's control of a corporation cannot be less than the value of the estate's voting stock.

Estate of Curry, 706 F.2d at 1427, citing Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1982).

On a somewhat similar point, in Ahmanson, an individual family member who owned 51% of an entirely family owned business was regarded as owning the controlling interest to which a control premium could be allocated. Ahmanson, 674 F.2d at 767-768. The fact that the shares held by the decedent ultimately may become divided was irrelevant for valuation purposes. Instead, the interest in the integrated estate formed the only basis for a valuation rationally comporting with the purpose of the federal estate taxes at issue.

In the instant case, the decedent owned a controlling interest in the corporation. The decedent owned the non-voting shares in conjunction with the majority of the voting rights in the company, rendering the lack of voting rights in the non-voting shares to be inconsequential. The non-voting stock was simply a portion of the decedent's bundle of equity interests in the company, constituting total voting control. Any control premium should be allocated to that whole bundle of stock rights. Therefore, to the extent a control premium is appropriate, the control premium should be applied to the entire bundle of stock owned by the decedent.

If [redacted] concludes that a control premium of [redacted]% is appropriate, the [redacted]% premium should be applied to integrated value of the block of stock owned by the decedent, i.e., the value of the shares of both the Class A voting and the Class B non-voting stock.

We hope the forgoing fully satisfies your inquiry, but if additional questions exist or as new questions arise, please contact the undersigned at (513) 684-3211.

MATTHEW J. FRITZ
Assistant District Counsel

By: _____
JAMES E. KAGY
Special Litigation
Assistant